FINANCE AND ECONOMICS

Latin America seeks shelter

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Will years of reform and sounder financial regulation make it easier to weather the currency-market storms?

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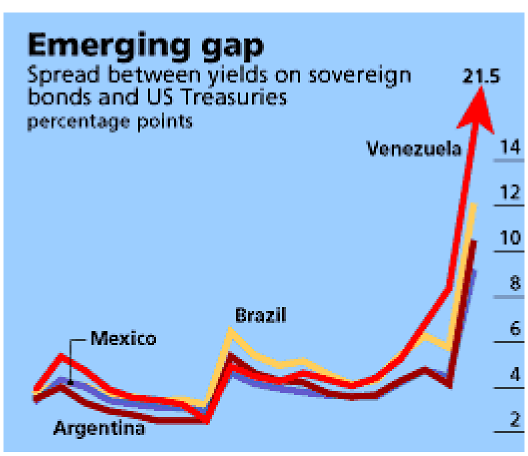
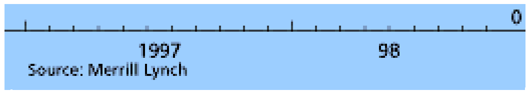
BRAZILIANS have a metaphor, derived from snooker, to describe the question that has faced Latin America's largest economy in recent months: is the *real*, their currency, the next ball to be sunk? No, officials insist. Brazil is not Russia, just as it was not Thailand, Indonesia, South Korea or any of the other unfortunate, once emerging, markets whose currencies have been blasted off the table over the past year or so.

Brazil's problems are indeed less severe than those of East Asia or Russia. But in the wake of Russia's devaluation and debt default, investor anxieties focused swiftly on Latin America, a region with a long history of both those actions. The message from the markets is that in a world with a sharply diminished appetite for risk, neither Brazil nor any other Latin American country can expect to escape without, at best, a sharp slowdown in growth.

Yields on Latin American bonds have surged as investors have sought safer havens. Those of Venezuela were hit especially hard, because of fears of a devaluation. But the spreads between Brazilian, Argentine and Mexican bonds and American Treasury bonds have doubled within the past month. Latin American shares have lost 25-30% of their value during August. Even Chile, for long the region's economic star, has not escaped. Its stockmarket index is at its lowest for four years.





As currency crises wracked East Asia last year, Latin Americans hoped that years of often painful free-market reforms would insulate their region. The economic fundamentals certainly seemed solid. Last year Latin America returned its best economic performance since the onset of its debt crisis in 1982. GDP grew by over 5%, inflation was less than 10%, and foreign direct investment arrived in record quantities. Thanks to costly bail-outs, tighter supervision and the expansion of foreign banks, financial systems are more robust than in the past. And the technocrats who run the main Latin American countries were in most cases quick to raise interest rates and tighten budgets as the first shock-waves from Asia hit last year.

But Latin America is not going to get off lightly. Economists were this week trimming their forecasts for the region's growth next year, to $1\frac{1}{2}$-$2\frac{1}{2}$%. The market crunch aside, one reason is the region's links to the American economy, which may soon slow. Another factor is Latin America's still disappointing export performance. The region remains uncomfortably dependent on exports of commodities, such as copper and oil, whose prices are likely to remain depressed as the world economy slows. And its manufactured exports have been hit by the strength of the dollar, to which most Latin countries peg their currencies.

The result is that this year, Latin America is set to post a record current-account deficit, of around $80 billion. That was not a problem as long as foreign capital was plentiful. No longer. And investors are unlikely to return to Latin American securities for several months, says Arturo Porzecanski of ING Barings. The risk is not (or at least not yet) of default. Foreign direct investment continues to flow in, and the region has already covered most of its external financing needs for the year. Rather, the challenge is to ensure that the adjustment to slower growth is as smooth as possible.

The chances of achieving this probably turn on Venezuela and Brazil. Venezuela is the more immediate, but less important, worry. Its oil revenues, which account for three-quarters of exports, have plunged to half their level of two years ago. That has strained the currency, which the government is reluctant to float because Venezuela already has Latin America's highest inflation rate. In addition, investors worry that the country might default on its debts after its presidential election in December, though most analysts think this unlikely.

Toxic cocktail

Brazil, meanwhile, is struggling with an economic-policy cocktail that blends a strong currency, loose fiscal policy and tight money. Its consequences are a current-account deficit of 3.9% of GDP, a fiscal deficit of 7% of GDP, and growing short-term public debt. The markets first showed their disapproval last October, when $7 billion left the country in a couple of days. The central bank doubled its main interest rate, but at the cost of killing consumer demand. The economy will do well if it grows by 1% this year. And investors' nerves are jangling once more. About $6 billion of foreign reserves has fled the country since the start of August.

For President Fernando Henrique Cardoso, who is seeking a second term in an election on October 4th, the timing could hardly have been worse. Rather than increase interest rates again, risking gloom among voters, this time the government has wheeled out its $69 billion or so of reserves, which, said the central bank, are "there to be spent" to prevent devaluation.

The central bank is also trying to woo money by fiddling with regulations: on August 24th it allowed foreigners to invest freely in short-term government paper. To finance its deficit, however, the government has had to assume risks. Not only is much of the 300 billion *reais* ($256 billion) of local-currency public debt in short-term paper, but a rising share (currently 60% of the total) is at floating interest rates. Were Brazil forced to raise interest rates, the cost to the government could be crippling.

This constraint on monetary policy means that Brazil will soon have to deal with two structural problems. The first is the public finances, which have deteriorated as promised spending cuts have failed to materialise and higher interest rates raised debt payments. The second concerns exchange-rate policy. Brazil is not alone in Latin America in relying on a strong currency to combat the region's ancestral vice, inflation. But as those rigid exchange rates require high interest rates, they impose a heavy penalty on growth.

Partly for that reason, Mexico may be the big Latin country best-placed to ride out the turbulence. Like Venezuela, it has been squeezed by low oil prices, which have forced budget cuts. But Mexico is alone among the big Latin economies in having a freely floating currency, which gives it more policy flexibility. Though the peso's recent slide against the dollar (it has lost around 25% of its value of a year ago) has sparked worries about inflation, most forecasts reckon Mexico will manage GDP growth of 3.5% or so next year.

Brazil's currency peg (the *real* depreciates around 7% a year against the dollar) has already cost it growth. That, say officials, is the price for cleaning up after decades of inflation. But the sooner the public finances are brought under control, the sooner the country can afford a more flexible exchange-rate policy without risking a return to inflation.

Argentina, Latin America's fastest-growing economy last year, has the most rigid exchange-rate system of all, with a currency board that fixes by law the value of the peso at parity with the dollar, and thus limits the money supply to the level of foreign currency reserves. Thanks to a well-regulated banking system and tighter public finances, Argentine officials are confident they can survive the current turbulence. If the worst comes to the worst, they might adopt the dollar instead of the peso.

Such a drastic step seems unlikely to be required. For all of their failings, most Latin American governments have relatively sound economic policies in place. When investors start worrying less about risk and more about the paltry yields available on rich-country securities, the region should quickly find itself back in fashion.